February 2008
Akira Kodama[1]
Center for Monetary Cooperation in Asia, International Department, Bank of Japan

Financial Issues in China from the Perspective of Japanese Companies and Banks

Summary of Discussions from "Research Group on Financial Issues in China"

1. Introduction

Rapid economic growth is giving the Chinese economy more and more weight in the global economy. Under these circumstances, how to deal with the Chinese market is becoming an increasingly important issue for both Japanese companies and banks. From the perspective of Japanese companies, for example, China is no longer just a production base for Japan or other countries ("the world's factory"). It also has gigantic domestic markets, particularly in the coastal regions, ("the world's market"), that are increasing in importance.[2] It should also be noted that many Japanese companies that establish production centers in China are increasingly procuring materials from local companies due to the development of supporting industries in the country.[3]

Under these circumstances, the increase in both domestic sales and domestic procurement of materials in China has triggered the need for companies to use the Chinese yuan (RMB) as the settlement currency by which they collect sales prices and pay for parts and components. As a result, it is becoming increasingly important for Japanese companies operating in China to raise RMB smoothly as operating capital. Another important task for Japanese companies is strengthening credit risk management, particularly through assessment and monitoring of the creditworthiness of Chinese companies and individuals to which Japanese companies sell their products. With the expansion of domestic sales, in an increasing number of cases, credit is extended to purchasers and consumers in the form of accounts receivable, automobile loans, etc.

For Japanese banks, supporting the operations of Japanese companies in China has become a priority business. A key challenge facing Japanese banks is smoothly conducting RMB-related business, including RMB-denominated loans that accurately respond to the fundraising needs of Japanese companies. Furthermore, when China joined the WTO in December 2001, it provided concessions on operations within the country by foreign banks, including banks from Japan. As promised, the final geographic and customer-based restrictions on RMB-related services were removed by the end of 2006, and it has become a very important issue for Japanese banks to formulate "Strategies for China" in order to strengthen their bases of operations in China by embracing these policy changes affecting foreign bank operations in China.

In other words, the expansion of business in China has brought both Japanese companies and banks more deeply into "the world of RMB finance," and has made it more important than ever to address the issues that these developments raise. This led to the organization of the Research Group on Financing Issues in China by the Center for Monetary Cooperation in Asia of the International Department at the Bank of Japan. This Research Group consisted of experts from the industrial and banking circles in Japan who are involved in business in China. The purpose of the Research Group was to discuss "the world of RMB financing" from practitioners' viewpoints by approaching the subject from various angles, including fundraising, funds settlement and credit risk management.[4] In the pages below, we summarize the major points arising from these discussions.

---

[1] Research Fellow, Center for Monetary Cooperation in Asia (akira.kodama@boj.or.jp)

[2] According to a survey by the Ministry of Economy, Trade and Industry, sales to the Chinese domestic market accounted for 55% of FY 2005 sales (by value) by the manufacturing subsidiaries of Japanese companies located in China (Ministry of Economy, Trade and Industry, "Survey of Overseas Business Activities", FY 2005 edition).

[3] According to the Ministry of Economy, Trade and Industry survey, local procurement makes up 52.4% of the whole by value.

[4] The Research Group met a total of 7 times between February and July of this year. Meetings began with presentations by members according to a set agenda, followed by open discussions.

(1st Meeting) Overview of the Research Group (February)

(2nd Meeting) Financial markets in China (March)

Participants in the China Financial Issues Study Group (Japanese phonetic order; * Rapporteur)

Masahiko Arakawa	General Manager, Credit Risk Management Division, Mitsui & Co., Ltd.
Masaaki Amma	Director General, JBIC Institute, Japan Bank for International Cooperation
Takehiko Ikushima	General Manager, Finance Department, Nissan Motor Co., Ltd.
Ritsuro Ishii	Senior Vice President, China Operations Promotion Department, Mizuho Corporate Bank, Ltd.
Koji Kanbe	Senior Vice President, International Banking Unit, Sumitomo Mitsui Banking Corp.
Shigeru Kido	Director and General Manager, China Finance & Accounting Solutions, Mitsubishi Electric (China) Co., Ltd.
Akira Suenaga	Joint General Manager, International Coordination Division, Mizuho Corporate Bank, Ltd.
Takayuki Suzuki	Senior Researcher, Asia Research Department, Mizuho Research Institute Ltd.
Kenichi Takayasu	Senior Economist, Japan Research Institute, Ltd.
Hideaki Tamiya	General Manager, China Business Division, Shiseido Co., Ltd.
Toshiaki Mugita	Deputy General Manager, China Division, Asian Headquarters, Bank of Tokyo-Mitsubishi UFJ, Ltd.
Ittetsu Mori	Manager, International Finance Team, Finance Section, Mitsubishi Electric Corp.
Yusuke Morita	Manager, Finance Division, Mitsui & Co., Ltd.
Akira Kodama *	Research Fellow, Center for Monetary Cooperation in Asia, International Department, Bank of Japan

2. Financial markets in China from the perspective of Japanese companies and banks

(1) Fundraising and funds management in China from the perspective of Japanese companies

The Research Group's sessions began with discussions of the current status and remaining issues or desirable improvements on several points related to the financial markets of China from the perspective of Japanese companies and banks. The discussion found that Japanese company interests revolved around how to raise RMB funds required for the expansion of business in China both smoothly and inexpensively. Many participants with a large number of subsidiaries in China also emphasized the need for more improvements in the RMB-denominated cash management system (CMS) to further strengthen funds management within the group and reduce external borrowing as a whole.

(Fundraising issues in China)

During the discussions, most time was spent on RMB fundraising issues in China, and many participants pointed out that raising RMB funds in China necessarily increases dependence on local bank borrowing.[5] In addition to bank borrowing, another option is for the Japanese parent company to lend (foreign

---

(3rd Meeting)	Issues in China's financial markets from the perspective of industrial companies (April)
(4th Meeting)	(1) Funds settlement in China; (2) Issues in China's financial markets (May)
(5th Meeting)	(1) Credit risk management from the perspective of industrial companies; (2) Credit risk management in China; (3) Credit risk in China (focusing on consumer finance) (June)
(6th Meeting)	(1) Assessment of financial market opening policies in China; (2) Trends among local banks and European/American banks in China (July)
(7th Meeting)	Major points of discussion in the "Research Group on Financing Issues in China" (July)

[5] At the time, parent company guarantees were attached in many cases.

currency-denominated) funds to subsidiaries[6] and then convert the funds to RMB locally. Furthermore, it has been pointed out that a considerable number of small and medium-sized enterprises make use of this system.[7] Among the companies participating in the Research Group, there was a generally common perception that “the path to issuing bonds and commercial paper (CP) in China is effectively barred, so if RMB funds are needed, companies basically have no choice but to rely on local bank borrowing.” There are three primary sources of local bank loans: Japanese banks, local Chinese banks and other foreign banks. In the specific cases presented by the members of the Research Group, there was overwhelming reliance on borrowing from Japanese banks, and there was a common trend for Japanese companies to rely heavily on Japanese banks for their local RMB fundraising needs.[8]

This dependence on bank borrowing to raise RMB funds in China is not unique to Japanese companies, or even to foreign companies in general. It reflects the Chinese financial system’s own heavy dependence on indirect finance, as noted repeatedly elsewhere. The Research Group noted that bank borrowing accounts for more than 80% of fundraising by non-financial sectors in China (Figure 1). The Chinese authorities have also noted the predominant share of bank borrowing in fundraising by the corporate sector, and have used the expression “inconsistencies resulting from the imbalance between direct and indirect finance in fundraising,”[9] and positioned it as a long-standing issue for China’s financial markets. As will be discussed later, there have been several recent attempts to develop capital markets, particularly bond markets. The Research Group felt that these trends need to be reviewed in conjunction with the discussion of the potential for bond issuing by foreign companies.

Figure 1: Fundraising by domestic non-financial sectors

(Unit: 100 million RMB)

	2005		2006	
	Amount raised	Share (%)	Amount raised	Share (%)
Total fundraising	30,677	100	39,874	100
Bank lending	24,617	80.2	32,687	82
Equity	1,053	3.4	2,246	5.6
Government bonds	2,997	9.8	2,675	6.7
Enterprise bonds	2,010	6.6	2,266	5.7

Note: “Domestic non-financial sectors” represents the total for ordinary consumers, enterprises and government.
Source: People’s Bank of China, China Monetary Policy Report

Beginning with the idea of “heavy dependence on bank borrowing,” the Research Group identified the following features (or issues) in fundraising from the perspective of Japanese companies.

(1) Bank loan terms

Not only does bank borrowing account for a large percentage of total fundraising, but a breakdown of loans by term indicates that short-term financing (within 1 year) is the primary component; many

[6] Regarding parent-subsidiary loans, small and medium-sized companies that cannot sufficiently staff their local finance departments often make use of parent-subsidiary loans to meet local funding demand, subject to the approval of the head office. The parent-subsidiary loans involve the transfer of foreign currency-denominated funds from the Japanese parent company. If RMB are ultimately required, the funds can be converted to RMB by registering an “external debt” with the State Administration of Foreign Exchange, by submitting documents attesting to the use of funds, etc. and receiving government approvals. However, it should be noted that the parent-subsidiary loans have the potential to be an expensive means of fundraising in the end because any payment of interest to the parent company by the Chinese subsidiary is subject to withholding tax.

[7] This cannot be ascertained quantitatively because there are no statistics on fundraising of Japanese companies in China that break down the funding sources (parent-subsidiary loans, local bank borrowing, etc.).

[8] Again, there is no quantitative data on the banking transactions of Japanese companies in China, but the Research Group members presented cases indicating that the most common source of funding is Japanese banks, followed by local banks and other foreign banks. However, for deposits, in a considerable number of cases, local Chinese banks have offices near local Japanese subsidiaries, and given the need for funds settlement, etc., Japanese subsidiaries conduct a relatively large volume of transactions with local banks.

[9] People’s Bank of China, *China Monetary Policy Report*, 4Q 2006.

comments indicated that the availability of medium- and long-term lending was "not fully assured." On this point, some commentators noted that when it was necessary to secure long-term funding, it was more advantageous from a cost perspective to roll over short-term loans because under the existing Chinese interest-rate regulations, interest rates increase with longer term loans. While there is a risk of being unable to roll over the loan due to changes in financial situations, given the very liquid state of current financial markets, it may be more rational to roll over short-term loans, even with such risk.

(2) Generous deposit/lending spread under regulated interest rates

China continues its efforts to employ market mechanisms in the formation of interest rates. For example, China introduced the Shanghai Interbank Offered Rate (SHIBOR) in the interbank market (discussed below). However, customer lending rates are still subject to government regulation and the deposit/lending spread is set very generously (Figure 2). This led to comments such as: "From the perspective of companies, this must be considered an advantageous interest rate system for banks," and "There is talk about reforms that will bring market mechanisms to the interbank market, but the deposit and lending rates that directly affect companies continue to be regulated, so companies have no perception of there being any changes as a result of these reforms." Conversely, some members also commented: "Given the financial state of local Chinese banks, it seems that China will have to maintain the current mechanism of generous interest spreads under regulated deposit and lending rates for a while longer. At some point, deposit and lending interest rates will be liberalized, but it will probably be quite some time before it happens."

Figure 2: Chinese deposit and lending base rates (one-year base interest rates) and spreads

(Unit: %)

	March 18, 2007	May 19	July 21	August 22	September 15
Lending base rate (A)	6.39	6.57	6.84	7.02	7.29
Floor (B < A x 0.9>)	5.751 8	5.913 8	6.156 8	6.318 8	6.561 8
Deposit base rate (C)	2.79	3.06	3.33	3.6	3.87
Deposit/lending interest spread (A – C)	3.6	3.51	3.51	3.42	3.42
Floor (B – C)	2.961 8	2.853 8	2.826 8	2.718 8	2.691 8

Note: Dates are the dates of base interest-rate changes. B expresses the minimum lending rate (0.9 x the base rate). The deposit base rate is the ceiling rate on deposits, so at the very least, banks can secure a spread of B - C.

Source: People's Bank of China

(3) Use of discounts on bills

In addition to bank borrowing, another short-term fundraising method is for banks to discount and cash bills received by companies in the process of commercial transactions. When doing so, the discount rate applied by banks is lower than the short-term lending interest rate for the same period,[10] and therefore many members look to make active use of discounts on bills as a means of reducing funding costs.

(4) Fundraising with bonds and commercial paper

Currently, foreign companies are effectively barred from raising RMB by issuing bonds or commercial paper (CP) in China, so a considerable number of the participants in the Research Group

[10] The rules for interest rates (discount rates) applied by banks when providing discounts on bills state that "the discounting bank shall add to the re-discounting rate of the People's Bank (3.24% since March 25, 2004) a bank margin within a scope not to exceed the lending base rate for the same term period". For example, the discount rate for a term of no longer than 6 months would be 2-3% lower in comparison to the lending base rate (currently 6.48%). It has been pointed out that discount rates have been held below regulated interest rates for the same terms because of a policy intention to promote the spread of bills as a means of inter-corporate settlement (Mizuho Research Institute, *Chinese Financial System and Banking Transactions 2006*).

expressed their desire for improvements in this area. China began issuing bonds in the 1980s with "Enterprise Bonds" issued by state-owned enterprises and similar entities. There were a number of conditions[11] put on issues, and it is thought that this practice has led to the infrequency of bond issues as a means of fundraising by non-financial sectors (discussed above). The common perception among participants was that the constraints on bond issues by Chinese companies, and particularly by non-state enterprises, for all practical purposes, barred foreign companies in China from fundraising through domestic bond issues in China.[12]

During the discussion, the position was forcefully made from the perspective of automobile sales financing[13] that "it is essential to be able to raise long-term RMB funds with bond issues rather than primarily relying on short-term bank borrowing in order to alleviate the term mismatch between the investment and the fundraising of our funding resources for automobile loans, which are long-term in nature. Regulations also result in high interest rates on loans, so we need to be able to use bonds and other fundraising instruments to reduce our funding costs as much as possible or it could undermine the entire automobile sales and financing business in China."[14]

On the other hand, CP started in May 2005 in the form of unsecured "short-term financing bills" (unsecured bills issued to Chinese banks as the primary underwriters for terms of no more than 1 year), and major Chinese companies make active use of it. Given the ability to raise funds at rates lower than those offered on bank lending,[15] many foreign companies also expressed a strong desire that they be able to use "short-term financing bills" in their fundraising.

As has already been noted, the Chinese authorities are aware of the "inconsistencies resulting from imbalance between direct and indirect finance in fundraising". During the third National Financial Work Conference held in January this year, the authorities unveiled a policy of "placing more emphasis on the development of capital markets by accelerating the development of the bond market".[16] Following up on this, in June, the China Securities Regulatory Commission promulgated "Experimental Measures for Corporate Bond Issuance" (effected in August).[17] This system clearly defines "Corporate Bonds" as bonds issued by ordinary joint-stock companies etc., and distinguishes them from "Enterprise Bonds," which are issued primarily by state enterprises and managed and overseen by the National Development and Reform Commission. Under the new rules, (joint stock) companies that meet certain eligibility conditions will be allowed to issue bonds with the approval of the China Securities Regulatory Commission.[18] The China Securities Regulatory Commission, which oversees

---

[11] (1) Issues of "enterprise bonds" are limited to agencies of the central government and state-owned enterprises, etc.; (2) Proceeds are to be used primarily for fixed asset investments, technology reform and rebuilding projects, etc., related to state industrial policy; (3) Issuing is subject to the review and approval of the National Development and Reform Commission. (Xinhua Online, "Similarities and Differences Between Corporate Bonds and Enterprise Bonds," August 14, 2007). There are also restrictions on interest rates (no more than 40% of the bank deposit interest rate for the same period of time) and issuing volumes (National Development and Reform Commission manages the annual issuing volume). (Mizuho Research Institute, *Chinese Financial System and Banking Transactions, 2006*).

[12] There have been some cases of foreign institutions issuing RMB-denominated bonds in China as nonresidents. For example, the International Finance Corporation (IFC) and Asian Development Bank (ADB) issued 10-year bonds in October 2005 (known as the "Giant Panda Bonds," issued at a value of 1.13 billion RMB and 1 billion RMB respectively), but no examples can be found of foreign companies with operations in China issuing RMB-denominated bonds.

[13] In October 2003, China promulgated the "Automobile Financing Company Management Law" allowing operations by foreign automobile financing companies.

[14] The Research group also learned of discussions on the liquidation of automobile loan credit as part of an expanded fundraising movement open to foreign automobile sales and financing companies.

[15] The interest rates on short-term financing bills are not subject to regulation, but are instead determined in negotiations between the issuer and the underwriting bank. In recent issues by major Chinese companies, the issuing rates have been around 5%, which is significantly lower than the interest rate on a one-year bank loan (7.29%). However, there are conditions on the issue of short-term financing bills, including: 1) the earnings and financial health of the issuing company, and 2) acquisition of a rating from a Chinese rating agency.

[16] Xinhua Online, "National Financial Work Conference Convened in Beijing, Important Address by Premier Wen Jiabao," January 20, 2007.

[17] China Securities Regulatory Commission, "Promulgation and Implementation of Experimental Measures for Corporate Bond Issuance," August 14, 2007.

[18] To be eligible to issue "corporate bonds," a company must: 1) cover annual interest payments on corporate bonds from annual average earnings available for dividends during the most recent 3 years; 2) have outstanding corporate bonds that do not exceed 40%

the program, has articulated guidelines stating that “for the foreseeable future, ‘corporate bond’ issues will be open only to companies listed on the Shanghai or Shenzhen stock exchanges or on foreign stock exchanges, and will be experimental in nature.”[19] Some point out[20] that this move could leave open the possibility for bond issues by foreign companies in China, which will require further monitoring in the future.

(Funds management issues in China)

In addition to fundraising, the Research group also discussed questions of funds management for corporate group companies in China, specifically, RMB-denominated cash management systems (CMS). In most cases, Japanese companies that focus their activities on domestic sales in China will have several different kinds of entities within their groups, including wholly-owned subsidiaries and joint ventures. In general, some of these entities will run cash surpluses while others will run deficits and depend on bank borrowing. One important task is to use a RMB-denominated CMS for these group companies to provide centralized funds management and promote borrowing and lending among group companies in order to reduce the external debt of the group as a whole.

Among the companies participating in the Research Group were some who had built a mechanism by which the group’s financial control unit[21] provided centralized management of funds at Chinese group companies. In addition, these participating companies emphasized that “when group companies managed their funds individually, we had cases in which both deposits and loans would simultaneously accumulate, but by using a RMB-denominated CMS to provide centralized funds management, this situation is gradually improving.” It should be pointed out that China prohibits the direct lending of funds between companies. As a result, schemes must make use of “entrust loans”[22] that go through an intermediary bank including the local branches of Japanese and other foreign banks, when concentrating surplus funds in the group’s finance company or financial management unit, and when the financial management unit lends funds to companies in shortfall. Future issues include the extent to which centralized RMB-denominated CMS can be expanded (it began with wholly-owned subsidiaries only, and there are questions regarding the extent to which joint ventures with Chinese partners can be incorporated into it, in particular, whether to require guarantees from Chinese partners when lending funds). In addition, from the perspective of centralizing financial functions, a comment was made that RMB-denominated, CMS-based funds management must be supplemented with centralized management by the financial management unit of bills received: “Currently, bills received at the time goods are sold are managed individually by group companies, but centralized management will result in discounts if at all possible so we can reduce our bank borrowing, which carries relatively high interest rates. This will further improve the efficiency of our funds utilization.”

(2) The short-term money markets and foreign exchange markets of China from the perspective of banks

In this section, we describe discussions held primarily from the point of view of Japanese banks regarding two topics: 1) short-term money markets, which are how banks invest and raise short-term funds among themselves (and are a particularly important source of RMB funding for foreign banks) and which in recent years have played an important role as a vehicle for monetary operations by the central bank; and 2) the foreign exchange market, where a number of reforms are in motion since the RMB’s transition to a “managed float” in July 2005.

(Short-term money market status and issues)

China divides its short-term money markets into three main categories: 1) the nationwide interbank call market, 2) the intra-industry lending market, and 3) the interbank bond trading market. This section begins with

---

of the company’s net assets; and 3) acquire a “good rating” from a ratings agency. The company may determine on its own how the proceeds will be used (including repayment of existing bank borrowings). Interest and other terms and conditions are determined based on the market environment.

[19] Xinhua Online, “Economic Observations: Corporate Bond Issues Formally Begin in China,” August 14, 2007.

[20] 21st Century Business Herald, “Will Multinational companies do RMB Corporate Bond hot dance?” June 25, 2007. Financial Times, “China Move Starts Bond Surge,” August 16, 2007.

[21] This differs from company to company, in some cases “financial companies,” and in others “finance centers”, etc.

[22] In this case, the surplus funds are entrusted to the intermediary bank, which is in charge of the procedures for transferring them to companies in shortfall. However, all movements of funds are subject to the instructions of the company using the system and the bank incurs no credit risk (but does earn commissions for the clerical processing). The company can similarly determine the interest rate applied to movements of funds in the scheme and is not subject to regulated rates.

an outline of each of these markets from the perspective of banking operations (Figure 3).

Figure 3: Outline of short-term money markets in China

	Main features
Nationwide interbank call market	• The market for unsecured call transactions ranges in term from overnight to 4 months. More recently, transactions of up to 1 year have also been allowed. In actual transactions, agreements are formed by adding a risk premium depending upon the borrower's creditworthiness. • The index rate for the market is the China Interbank Offered Rate (CHIBOR), but this is announced subsequently as a weighted average of call-market transactions for the day, and calculations include the risk premium charged to counterparties. The rate is also subject to wide swings depending on day-to-day trading volumes. • By contrast, the Shanghai Interbank Offered Rate (SHIBOR) began being published in January as an average rate offered by "reference banks"[23] as of 11:00 a.m. each day. This rate does not include risk premiums and tends to be highly correlated to the bank repo rate (see below) and is therefore receiving attention as a benchmark interest rate in place of CHIBOR (in actual transactions, rates are set at SHIBOR plus a risk premium for the counterparty).
Intra-industry lending market	• This was originally a market for counterparty transactions among banks for funds with terms in excess of 4 months (though, it is now possible to enter into transactions of between 4 months and 1 year on the nationwide interbank call market). In actual practice, it is rare for agreements to be reached for transactions in excess of 1 year.
Interbank bond trading market	• This market allows for both cash bond and bond repurchase (repo) trading, and has the highest trading volume of the three markets,[24] in part because repo transactions are bond-secured loans. • The repo rate is considered a base interest rate for short-term money markets and its levels generally correlate with those of SHIBOR.

Source: Research Group documents.

The following features were identified in China's short-term money markets:

(1) Market participants include the four largest state-owned commercial banks (Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Agricultural Bank of China), with other local Chinese banks, foreign banks, securities companies and funds, and insurance companies. However, the providers of funds are perennially the four large state-owned commercial banks, which carry large surplus funds, and the market's trading volumes and rates are significantly influenced by the moves of these banks.

(2) The absolute number of market participants is low and transactions generally congregate in the overnight to 7-day range (for terms in excess of 7 days, trading volumes and absolute numbers undergo a steep decline).[25]

(3) Given the low number of market participants and the predominant weight of the four major state-owned commercial banks as the providers of funds, the market structure is in general not conducive to arbitrage (there are often regional differences in rates).

Figure 4: Supply and Funding in short-term money markets

(Unit: 100 million RMB)

	2003	2004	2005
State-owned commercial banks	-75,150	-51,254	-94,270
Other commercial banks	45,361	27,486	35,277
Other financial institutions	17,341	9,882	23,522

[23] It is said that reference banks tend to be very aware of the bond repo rate when quoting their rates.

[24] For 2005, trading volume on the call market was 1,278.3 billion RMB, while the interbank bond market traded 6,013.3 billion RMB in bond spots and 15,900.7 billion RMB in repos.

[25] For the call market, transactions in the overnight to 7-day range account for 89.6% of total volume. For the bond repo market, they account for 88.4%. (2006 actual numbers used for both).

Insurance companies	605	1941	9,956
Securities companies/Funds	11,561	11,156	18,630
Foreign financial institutions	282	779	6,885

Negatives indicate discharge; positives indicate take-up.

Source: People's Bank of China

Within this context, the Research group was particularly interested in the SHIBOR, which began to be published in January of this year as a benchmark rate for the interbank call market. The People's Bank of China first began using the SHIBOR as a base rate for monetary operations (reverse repo transactions) that it performed in February, and the members of the Research Group generally appreciated what they perceived as the Chinese authorities' strong intentions to establish SHIBOR as the benchmark rate. Subsequently, the SHIBOR has been used as the benchmark rate for determining the interest rates on "short-term financing bills" (Chinese CP) and floating rate bonds etc.,[26] but there was a common perception that developments would need to be monitored to determine whether SHIBOR will be used and established as the benchmark rate for other financial transactions in China including interest-rate swaps and derivatives.

One perception voiced by Research Group members was that, from the perspective of Japanese and other foreign banks, the short-term money markets "are an important source of RMB funding," but "it will be difficult for Japanese and other foreign banks to emerge as main players in the RMB money market, in part because of their relatively short history in the market." Regarding RMB-denominated funding, members of the Research Group noted that foreign banks are far inferior to local banks in their ability to attract and absorb deposits because they do not have the same branch office networks. Therefore they expressed a strong desire to "open up means of financing that would expand RMB funding, such as the issuing of CDs and bonds by foreign banks."

(Foreign-exchange market status and issues)

In July 2005, the Chinese FX system moved to a "managed float exchange rate regime with reference to a basket of currencies," and there have been concerted efforts to enhance foreign exchange markets since that time in line with subsequent changes in the RMB rate. Some of these efforts include enhancements to the futures market in the form of a repeal of the ban on foreign-exchange swaps, and the introduction of a market-making system and a primary dealer system. There was a consensus in the Research Group that efforts to enhance the market should be more appreciated. However, China undeniably continues to maintain regulatory control under the principle of trading based on real demand, and the incremental nature of market improvements.

A number of future issues were identified, including: 1) mechanisms to ensure that contracts are valid and binding (including liquidation methods in the event that one of the parties defaults, as well as other enhancements to the legal framework for foreign exchange trading); 2) establishment of standard contracts and market practices; and 3) enhancements of accounting treatment standards and taxation. One group member felt that "an issue for the authorities will be how to balance the real demand principle and the need to develop markets. In order to foster markets, the authorities should not be obsessed with the real demand principle but should allow participants to do a certain amount of position taking." Other comments raised during the discussion include, "When you combine foreign currency borrowing with foreign exchange swaps and then make these virtual RMB funding, there is the potential for fundraising costs to be below regulatory interest rates depending on where the swap rate is set, and authorities need to consider how to deal with such cases in the future in relation to regulated interest rates," and "There will be a need to provide medium- and long-term foreign exchange risk hedging instruments[27] such as the use of currency swaps."

3. Issues with payments and settlements in China

[26] In April of this year, SINOPEC, China's leading petroleum company, became the first to issue a 1-year short-term financing bill using SHIBOR as the benchmark rate (issuing rate: SHIBOR + 1.07%). This trend has continued (China Securities Journal, April 24, 2007). In June, China Development Bank, one of China's "policy banks," issued the first 5-year bond using SHIBOR as the benchmark (3-month SHIBOR + 48 bp, issuing value of 10 billion RMB). Subsequently, the trend has reportedly spread to other enterprise bonds under the jurisdiction of the National Development and Reform Commission (Financial News, June 20, 2007; Shanghai Securities News, September 27, 2007).

[27] It should be noted that the People's Bank of China announced in August the commencement of currency swap trading on the interbank market.

The payment and settlement system in China was another topic taken up by the Research Group. Discussions attempted to evaluate the current status and identify issues from three specific angles: 1) means of funds payment in China, 2) interbank payments system, and 3) practical issues.

(1) Means of funds payment in China

The Research Group heard explanations of the means of funds payment currently available in China. Instruments other than cash are categorized into two main groups: 1) checks, normal and telegraphic transfer for payments within the same clearinghouse territory; and 2) telegraphic transfer and various forms of bills (banker's bills, trade acceptance bills, bank acceptances) for payments between remote territories. Recent years have seen greater use of cards as a means of payment in major urban areas in China, but the Research Group was informed that in China's case, these cards (primarily debit cards) do not have overdraft functions.[28]

Among these instruments, bills and checks are the most closely related to corporate activities. In China, they are subdivided into five categories[29] (Figure 5), which are used according to the nature of the payment, for example, whether the activities are within the territory of a single clearinghouse or involve remote areas.

Figure 5: Bills and checks in China

Name	Function	Time to settlement	Payment term	Scope of circulation	Potential for dishonoring (see note)
Check	Equivalent to a check in Japan	Cashed at next clearing after presentation	10 days after issue	Only within the same clearinghouse	Yes
Promissory note	Check issued by bank after receiving an equivalent amount in advance from party requesting issue	Cashed immediately upon presentation	2 months after issue	Only within the same clearinghouse	No
Trade acceptance bill	Bill of exchange in which the payer promises payment upon maturity	Differs according to the location of the counterparty bank	6 months after issue	Nationwide	Yes
Bank acceptance	Bill of exchange underwritten by a bank based on a payment entrustment agreement between the bank and the issuer (promise of payment by the bank)	Differs according to the location of the counterparty bank	6 months after issue	Nationwide	No
Banker's bill	Bill of exchange by bank after receiving an equivalent amount in advance from party requesting issue	Next business day after presentation for clearing	1 month after issue	In principle, circulates with clearinghouses other than the clearinghouse of the issuer/bank	No

Note: In this context, "dishonoring" refers to the return of a bill because the payer has refused payment or has an insufficient balance; it excludes bank-derived events such as the risk of bank failure.

Source: Research Group documents.

[28] Unlike credit cards, debit cards can be used for payments, etc. of purchases covered by the balance remaining on the account. According to the People's Bank of China, at the end of 2006 there were a total of 1.08 billion debit cards issued, which accounted for 95.6% of all the cards issued in China. People's Bank of China also says that debit cards and credit cards were used to settle 17% of total retail sales in 2006.

[29] A total of 1.19 billion bills and checks were issued in 2006 with a total value of 224.7 trillion RMB. Of this figure, the vast majority, 1.17 billion, were checks, with a total value of 208.5 trillion RMB.

The Research Group was particularly interested in the positioning of the dishonoring system in China. In the case of checks, the Chinese rules covering dishonoring provide for: 1) imposition of fines (5% of the face value of the check or a minimum of 1,000 RMB), 2) inclusion on a blacklist, and 3) suspension of bank transactions (for repeated dishonoring). In addition, if the issuer fails to pay the fine by the specified deadline, the People's Bank of China may add additional fines and/or request a suspension of check issuing by the transacting bank. Similarly, the dishonoring of a bill is also subject to fines (0.07% of the face value per day), and repeat offenses may lead to a suspension of bank transactions, according to the rules as explained to the Research Group (however, the creation of a blacklist of issuers dishonoring bills is still reportedly in its study stage).

While these systems are in place, the response to dishonoring in general lacks the same degree of severity as in Japan, which becomes an issue in relation to credit risk management in China (discussed below). One opinion heard was that "foreign companies need to pay sufficient attention to the dishonoring risk when handling bills and checks in China, the exception being 'banker acceptances.'"[30]

(2) Interbank payments system

The Chinese interbank payment system was explained as having two primary components: 1) payment systems within a single bill clearinghouse, and 2) payment systems that allow use of both a single bill clearinghouse and clearinghouses in remote areas. Of these, the first, the "Local Clearing House System" (LCHS) handles all receipts and disbursements for bills and checks between banks (as noted above, checks account for a far greater percentage than bills). An LCHS is provided by more than 2,300 clearinghouses operated around China by the People's Bank (each bank or each branch office has a settlement account with the local People's Bank, and net settlement is made on these accounts). Clearinghouse settlement is normally performed once a day, although in urban areas and other locations with high transaction volumes there may be two settlements per day (morning and afternoon). Bills brought to the clearinghouse in these regions can be settled within 24 hours. Some locations have their own local clearinghouse systems, and Shenzhen and Suzhou, for example, have electronic clearing systems.

Within the second category, payment systems that allow use of the local and remote clearinghouses, there are two further categories: systems operated by the People's Bank of China, and systems operated independently by state-owned banks. The Research Group was furnished with an outline of both systems (Figure 6).

[30] There is an exception for bank acceptances because they are perceived as very safe and close to a "bank guarantee." However, legal counsel has provided the opinion that "the bank does not legally guarantee certainty of payment," and some members of the Research Group therefore advised caution with these instruments as well.

Figure 6: Outline of interbank payment systems in China

Systems operated by the People's Bank of China	Systems operated independently by the state-owned commercial banks
▽ China National Advanced Payment System (CNAPS). Entered into nationwide operation in June 2005. ▽ Comprises 3 different systems: 1) the High-Value Payment System (HVPS) for large payments; 2) the Bulk Electronic Payment System (BEPS) for smaller payments; and 3) the National Cheque Image System (CIS) for check settlement between remote locations. - (1) The High-Value Payment System began nationwide operation in June 2005. It provides real-time gross settlement for individual instruments with a value over 20,000 RMB. - (2) The Bulk Electronic Payment System finished nationwide deployment in June 2006. It provides fixed-time net settlement 3 times a day for instruments valued at 20,000 RMB or less. - (3) CIS was developed to enable checks, which traditionally have only been used within the local clearinghouse, to be used as a means of payment between remote locations by sending the image data of the check to the paying bank for settlement[31] (completed nationwide deployment in 2007).	▽ The large state-owned commercial banks have offices throughout China and their own independent electronic payment systems. These systems provide payment and settlement between the banks' head and branch offices, generally in a short period of time, though this will depend upon the locations and amount to be settled. - In many cases, urban commercial banks, rural credit companies and Japanese and other foreign banks that do not have the kind of branch office networks that the state-owned commercial banks enjoy, sign contracts with the state-owned commercial banks to make use of their services for funds settlement between remote locations rather than going through CNAPS. ▽ In addition, urban commercial banks and rural financial institutions may also have their own independent payment centers and are building payment networks.

Source: Research Group documents.

All banks licensed to provide RMB services, including foreign banks, are in principle required to join CNAPS, which is operated by the People's Bank of China. Participation can be either direct or indirect. Direct participants connect their internal systems to the CNAPS system to accelerate internal payment processing and make use of payment data within the bank's internal systems. Research Group participants felt this offers major benefits (indirect participants are required to manually process payments data within their internal systems). A considerable amount of interbank funds payments continues to be handled by the internal systems of the state-owned commercial banks,[32] but CNAPS is steadily improving. The Research Group felt that "as CNAPS becomes easier to use, there will be a shift in payments processing from the internal systems of the state-owned commercial banks to CNAPS."

(3) Practical issues

Finally, the following practical issues were raised from Research Group members regarding funds payments in China.

1 Issues with CNAPS itself

The BEPS, which is the CNAPS small-value payments system, completed nationwide deployment in June 2006. However, this only covers payment values up to 20,000 RMB, so it is not used as much as originally envisioned when BEPS was being developed, and many felt that it had not achieved the expected results. (Conversely, the load on the HVPS high-value payment system is larger than initially envisioned). Some suggested that further improvements were required, for example, the maximum value should be raised for the small value payments system so that it could be used more frequently,

[31] To provide for problems and mitigate risks, checks have a maximum value of 500,000 RMB.

[32] According to the People's Bank of China, the internal systems of state-owned banks processed a total of 1.53 billion payments during 2006, worth a total of 225.6 trillion RMB, which is on a par with the processing done by the CNAPS high-value payment system (140 million payments worth 257.5 trillion RMB).

which would reduce transaction costs. Similarly, the National Cheque Image System that transmits image data of checks, has been late in providing the legal framework for forged checks or improperly issued checks, and many felt that further efforts would be required in this area in order to promote usage.

2 Practical issues experienced by banks in the use of CNAPS

Research Group members pointed to inadequacies in the CNAPS database that lead to greater processing burdens on banks.[33] For example, there are mix-ups because the CNAPS database has incorrectly input bank names or has not assigned bank code numbers according to the rules, leading to cases of banks not appearing in the database even though they are members of CNAPS. The Group's opinion was that "failure to improve the database and mitigate processing burdens could put the brakes on efforts to promote use of CNAPS."

3 Certainty of funds transfer

From the perspective of companies operating in China, a comment was made that the certainty of funds transfer is not necessarily assured. For example, the Research Group heard reports of a Tokyo head office transferring (foreign-currency) funds for a capital increase to the local China subsidiary's account with a local Chinese bank, but being unable to immediately confirm the deposit to the local bank account. In addition, the funds were not deposited as initially scheduled, which resulted in difficulties with the local authorities when taking capital increase procedures. Other examples include sales prices being deposited in the course of ordinary commercial transactions but lacking ancillary information regarding the relevant transactions and requiring inordinate amounts of time for reconciliation.

4. Issues with credit risk management in China

(1) Views on credit risk in China

The next topic taken up by the Research Group, and one in which there was intense interest, was issues involving credit risk management in China, particularly collections of accounts receivable credits and the like. As their sales in China increase, Japanese companies are developing a strong awareness of "accounts receivable collection risk" to which they are exposed.[34] The overwhelming majority opinion in the Research Group was that because of the current boom in the Chinese economy, there have been no major defaults on accounts receivable credits yet, but there continue to be numerous cases of delayed collections that do not reach the level of default. This makes it difficult to take on credit risk exposure actively, which is an impediment to the development of domestic sales businesses in China. From the perspective of automobile sales financing, the opinion was voiced that "there are rampant problems, including the lack of credit information on customers and even investigation methods. When starting up businesses, operators will be forced to engage in difficult, cumbersome work in conjunction with credit screening, such as actually checking the status of the customer's house."

Behind this awareness of risk is a very cautious attitude on the part of Research Group members towards collections of sales prices. More specifically, members repeatedly explained that they worked on a "cash in full on delivery" basis, or required prepayment either in cash or in cash plus bank acceptances, or only shipped products after confirming that the customer had made the bank transfer. Even when credit sales are generated, members explained, "We have a rigorous selection process to identify purchasers who are extremely creditworthy and even then have a system of closing accounts at the end of the month and requiring payments the next month. If collections are delayed, we immediately repossess the merchandise after the 3rd warning." Another commentator said, "The recovery period for accounts receivable is still about two months on average for China as

[33] According to members, the problems are particularly acute for bank code numbers. The CNAPS coding system uses a bank code (3 digits) followed by a regional code (4 digits) and a branch code (5 digits). However, members indicated that "there are cases of different banks having the same initial 3-digit code, and a substantial amount of other confusion in the system, requiring operators to manually reference code tables for each payment and find the correct recipient bank code, which is an inordinate amount of work."

[34] For example, according to a JETRO survey, ("Survey of Domestic Sales Activities of Japanese Companies in China," August 2002) when asked, "What is the biggest issue you face with domestic Chinese sales?", 75.3% of companies responded "accounts receivable collections," making it far and away the top item (followed by "understanding market needs" at 28.5% and "rampant piracy" at 25.3%).

a whole. However, payment by Chinese companies to which merchandise is sold can, in some categories, be made in a lump sum every December, which creates cases requiring 7-9 months from shipping to collection, and this obviously requires companies to exert sufficient care." It should be noted that there is considerable variance among Japanese companies regarding their specific collection policies and that these will depend upon the conditions and environments in which they find themselves.[35] In light of the JETRO survey it would appear that the perception that extreme care is required in collections on domestic Chinese sales is not limited to the members of the Research Group but is commonly held by Japanese companies doing business in China.[36]

(2) Issues with credit risk management in China

The Research Group identified several reasons why Japanese companies maintain a cautious stance against exposure to credit risk in conjunction with domestic Chinese business.

1 The difficulty in identifying and monitoring the status of Chinese counterparts

From a company standpoint, it is not necessarily an easy task to obtain statements of accounts from Chinese counterparts, and even when obtained, there are often questions regarding their reliability. Many commentators noted the "extreme difficulty" of monitoring companies merely with financial statements or other published financial information (there are numerous cases of window dressing and large variances in the quality of auditing performed by different CPA firms, leading to the widespread opinion that merely having been screened by auditors was not necessarily reassuring[37]). It was also widely held that there are delays in the disclosure of corporate bankruptcy information[38] and that lack of specific public information on what kinds of bankruptcies are occurring in which sectors makes it difficult to narrow down the sectors that should be approached with caution. This forms a significant impediment to companies' credit policies. One comment regarding information disclosure from the perspective of automobile sales financing was, "Only banks have access to borrower credit information;[39] we would like to see improvements in the system so that non-banks like automobile sales financing companies can also have access to this information."

2 Insufficient means to preserve the integrity of credits

The common perception in the Research Group was that the lack of sufficient means to preserve the integrity of credits formed an impediment to credit-based transactions in China. For example, when real estate is provided as collateral[40], the immaturity of the real estate market makes it difficult to value the collateral. Also, there are bottlenecks in the form of restrictions on perusal of real estate deed registrations. Lack of an adequate legal framework also makes it difficult to use movables as collateral[41]. Guarantees are a relatively easy-to-use means of preserving the integrity of credits in China. However, when the credit obligations incurred by Chinese companies are denominated in

---

[35] For example, one comment made in the Research group was, "It is easy for prepayment to be accepted if the company has established its brand in China, if its merchandise is of high quality, or if the number of suppliers is otherwise limited, but if the merchandise is more of a commodities product and there are many different suppliers, companies may be forced to accept some amount of accounts receivable as part of their sales strategy."

[36] According to the JETRO survey ("2006 Survey of Japanese Manufacturers in Asia (China, Hong Kong, Taiwan and Korea)"), when questioned about collections in China, 52.6% of the responding companies (462) reported using "lump sum accounts receivable" which was lower than the percentages for Hong Kong, Taiwan or Korea, about which they were also surveyed at the same time. Additionally, 12.2% reported using "advance payment in full" or "payment in full upon delivery," which was higher than the results for other countries and regions. Likewise, 24.5% reported using a combination of partial prepayment and accounts receivable, which was again higher than for other countries and regions. This would indicate that Japanese companies have reservations arising from the difficulty of collections in China and are taking commensurate measures.

[37] Among the comments, it was pointed out that the balance sheets of Chinese companies continue to post inventory assets, accounts receivable and other items that are actually in default, in part because the tax code does not allow posting to reserves against default, except in some exceptional situations.

[38] The statistics indicate that there were 4,953 corporate bankruptcies in China in 2004, but there is no detailed information regarding them (specific company names, addresses, nature of business, nature of bankruptcy, total liabilities, major creditors, etc.).

[39] The People's Bank of China is currently taking the lead in creating a database of personal and corporate credit information in China, but use of this database is limited to banks.

[40] In these cases, collateral is only for land usage rights.

[41] More specifically, to use a counterparty Chinese company's merchandise or its accounts receivable credits, etc. against third parties as collateral.

foreign currencies, they must be registered in advance with the State Administration of Foreign Exchange as “external debts” or it is impossible to receive subrogation from the guaranteeing Chinese company at the time the guarantee is executed.

3 Chinese companies showed little awareness of the problems created by delayed payments

The late payment is not limited to companies with poor results; many participants said there were many cases of payment delays even among strongly performing companies. Many different contributing factors were noted: “Lack of awareness that payment delays are bad,” “Business practices of not making payment unless demanded,” “Priority in payments to companies with whom there are strong relationships and other tendencies to prioritize payment orders” and “Different payment methods depending upon the merchandise.” In addition, many members also pointed to the inadequacy of the dishonoring system (discussed above) as having an impact on the payment practices of Chinese companies.

4 Insufficient means of legal resolution when there are disputes

Comments included: “From the perspective of foreign companies, when there are disputes and they are litigated, there is a tendency for the judicial verdict to be influenced by the desires of the government,” “There is a tendency for inconsistency in legal interpretations from ruling to ruling,” “When there is a dispute between a local company and a foreign company, local protectionism sometimes results in rulings that favor the local company”, and “The mandatory execution procedures are inadequate and collection rates are not necessarily high.”

(3) Desired improvements

The Research Group felt that improvements were desired on the following points because the sound development of a credit economy would significantly benefit not only foreign companies active in China but also Chinese companies themselves.

1 Promotion of greater accuracy in the financial statements of Chinese companies and greater information disclosure

The sound development of a credit economy requires that market participants be able to fully ascertain the status of counterparties so that they can perform appropriate credit risk management. There was a common awareness that this should be facilitated by improving the accuracy of financial statements, for example, allowing appropriate inclusion in the reserves against default, and promoting greater information disclosure. Specific opinions included: “There need to be improvements in the levels of CPAs so that there is better-quality auditing, and also an expansion in the companies subject to auditing”, and “There should be a system where anybody can easily access corporate information, including corporate default information.”

2 Improvements to collateral systems

To enhance systems for preserving the integrity of credits, many members felt that China required further enhancements of its real estate market and public access to real estate registrations. There were also calls for enhancements of the legal framework for real estate collateral.

3 More effective sanctions against dishonoring

A large number of comments noted the need for the establishment of sanctions against the dishonoring of bills and checks in order to better discipline companies to pay properly.

4 Improvements to the judiciary system

One comment received was, “In addition to integrating and standardizing legal administration around the country, it is vital that China facilitate economic activities by accumulating not only legal interpretations but precedents in order to provide for greater stability in the administration of the law.”

In this regard, China also noted in recent years that the market economy is essentially a credit economy and normal corporate activities are significantly impeded by frequent delays in collection of accounts receivable and defaults on debts. Addressing the circumstances will require efforts on the part of enterprises to strengthen their own credit risk management functions.[42] The Research Group considered this a trend to be watched in the future.

5. China's financial market opening policies

As its final theme, the Research Group discussed the financial market opening policies of China. China acceded to the WTO in December 2001 and at that time provided concessions on the opening of its financial services sector to foreign institutions, promising to phase in RMB services in China for foreign banks, among other measures, and announcing guidelines to gradually implement these measures over a 5-year period after WTO accession (Figure 7). In November of 2006, the final year of the phase-in, China opened retail RMB services to foreign banks under the principle of "national treatment," the last item left on the list. This was done under the "Regulations of the People's Republic of China on Administration of Foreign-funded banks." With this step, China fulfilled its concessions made at the time of WTO accession. In the Research Group, members discussed their appraisal of China's efforts to open its financial markets, particularly in the banking sector, trends among local Chinese banks as they endeavor to strengthen their operations, and strategies by European and American banks since they, just like Japanese banks, are taking an aggressive stance towards the Chinese market.

Figure 7: Concessions made by China regarding the opening of its financial markets at the time of WTO accession

	Major concessions
Banking	• Elimination of geographical and customer restrictions on foreign currency services by foreign banks at the time of WTO accession. Relaxation of geographical and customer restrictions on RMB services to be phased in and ultimately eliminated by December 2006.

	Foreign currency services	RMB services	
		Elimination of geographical restrictions	Elimination of customer restrictions
Prior to WTO accession		Shanghai, Shenzhen	Foreign companies, foreign nationals
Time of WTO accession	Elimination of geographical-customer restrictions	Tianjin, Dalian	
Within 1 year		Guangzhou, Zhuhai, Qingdao, Nanjing, Wuhan	
Within 2 years		Jinan, Fuzhou, Chengdu, Chongqing	Services for Chinese companies
Within 3 years		Kunming, Beijing, Xiamen	
Within 4 years		Shantou, Ningbo, Luoyang, Xian	
Within 5 years (December 2006)		Fully open	Services for individual Chinese customers

Note: The place names in the "elimination of geographical restrictions" column are cities where RMB services were opened to foreign banks at the time noted.

[42] Market News, August 10, 2006. This article states that in the case of Chinese companies, losses due to inability to collect accounts receivable credits, etc. amount to around 14% of total sales.

Securities	• At the time of WTO accession: Foreign securities companies allowed to mediate trades of B shares, open offices in China, obtain special membership in China's stock exchanges and establish joint ventures in fund management (foreign stake of no more than 33%). • Within 3 years of WTO accession: Foreign stake in joint venture fund management companies increased to a maximum of 49%, establishment of joint venture securities companies (foreign stake of no more than 33%) allowed (able to mediate trades of A, B and H shares and underwrite government bonds, etc.).
Insurance	• Within 3 years of WTO accession: Geographical restrictions lifted on both life and non-life insurance. • When establishing joint venture companies, some restrictions remain for life insurance (foreign stake of no more than 50%), but wholly foreign-owned non-life insurance subsidiaries allowed. • In operations, substantial relaxation of restrictions within 3 years of WTO accession (able to provide a wide range of insurance services in China).

Source: Research Group documents.

(1) Assessment of China's financial market opening policies

The members of the Research Group recognized that China has faithfully fulfilled the concessions it made to open its financial markets at the time of WTO accession, but argued that financial reforms have strengthened local Chinese banks and the Chinese authorities have maintained their basic guidelines that Chinese banks would continue to be the core of the financial system (avoiding the "Wimbledon phenomenon").

Within this context, major European and American banks that are able to enjoy the benefits of the opening policies have for several years invested in a considerable number of local Chinese banks as "strategic investors," and have cooperated in order to improve their management systems, including stronger risk management.[43] With the pathway now open to providing retail RMB services under the "Regulations on Administration of Foreign-funded Banks," several banks have already decided to establish local subsidiaries that are required by the Regulations (Figure 8).[44] On the operations side, banks have different priorities, but many have begun to actively enter the retail market this year, providing personal RMB-denominated deposits and handling home loans, for example. In this regard, one member commented, "The leading European and American banks are not 100% satisfied with China's opening of its financial markets, but can give it generally high marks in the sense that it has brought new business opportunities." According to BIS statistics, European and American banks, and particularly British banks, have seen a notable increase in their outstanding credits to China (Figure 9), which is a sign of their aggressive stance towards doing business in China.

Figure 8: Main points regarding the opening of RMB services to foreign banks under the "Regulations on Administration of Foreign-funded Banks"

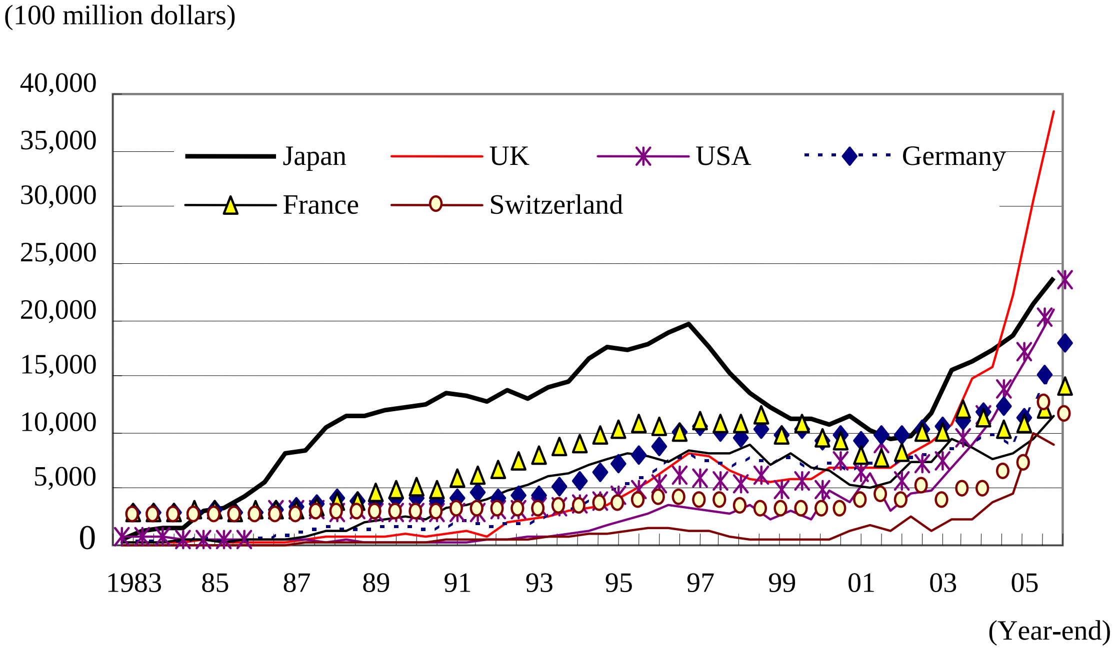
1. Establishment of a local subsidiary (status as a wholly-owned foreign bank subsidiary or a China-foreign joint venture bank) required to provide consumer RMB services within China (in addition to foreign-currency services, all consumer RMB services, including card services).
   - Minimum capitalization of 1 billion RMB required (also, statutory capital of 100 million RMB when opening new branches).
2. Operations are also possible as a branch office. The scope of services includes foreign-currency services and non-consumer RMB services (however, consumer time deposits of 1 million RMB or more can be handled upon acquisition of a permit).
   - Minimum capital of 200 million RMB required.

Source: Research Group documents.

[43] According to the "Report on the Opening up of the Chinese Banking Sector" (March 2007), 29 foreign banks, primarily from Europe and America, had invested a total of 19 billion dollars in 21 local Chinese banks at the end of 2006 and had "contributed to the strengthening of capital, application of international standards regarding capital adequacy ratio, improvement of governance and diversification of shareholders, etc.".

[44] Banks may make their own choices as to whether they establish local subsidiaries or continue to operate as branch offices, but the Chinese authorities (China Banking Regulatory Commission) have articulated clear guidelines that "recommend for foreign banks with a number of branch offices in China, the establishment of a local subsidiary to provide large-scale deposit services and develop RMB retail services". (China Banking Regulatory Commission 2006 annual report; this policy is known as the "Local Incorporation Oriented Policy"). At the end of 2006, 9 foreign banks had been given permission to establish local subsidiaries.

Figure 9: Outstanding credits to China of BIS reporting banks



Source: Study Group documents (posted on BIS website)

By contrast, while there are some Japanese banks that, like their European and American counterparts, have decided to establish local subsidiaries, one commentator said, "One of the things that characterizes Japanese banks is that most of their services are for Japanese companies with operations in China and there are few incentives to move aggressively into retail services. Therefore, there are probably some slight differences in how they view China's opening policies compared to European and American banks."

Another opinion about the impact of these measures on the operations of foreign banks in China was, "They will probably bring new energy to the operations of foreign banks in China thanks to the full opening of domestic RMB services, including the retail market. However, considering the broad office networks that the four major state-owned commercial banks and other local Chinese banks have already built, there will be natural constraints on how far foreign banks can expand their operations, particularly as they continue to concentrate on a handful of coastal cities." It should be noted that foreign banks' share of total bank assets in China is gradually on the increase, but is currently only 2% (Figure 10).

Figure 10: Foreign banks in China

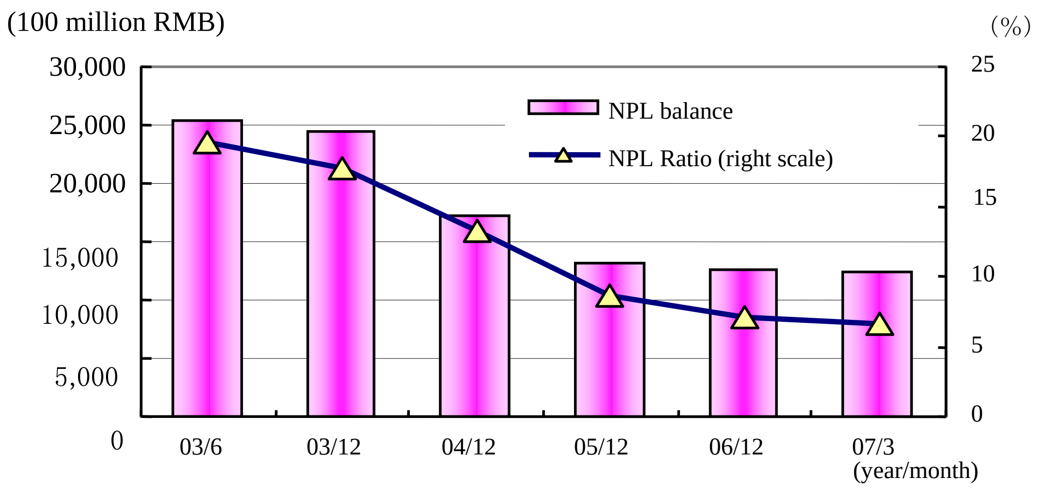
	2003	2004	2005	2006
Number of offices	192	211	254	312
Assets (100 million RMB)	4,159	5,823	7,155	9,279
Share of total bank assets (%)	1.5	1.84	1.91	2.11

Source: China Banking Regulatory Commission

(2) Trends among local Chinese banks

During the "grace period" leading up to the full opening of domestic RMB services to foreign banks, local Chinese banks worked to clean up non-performing loans and strengthen their operations. Non-performing loans were transferred to asset management companies and public capital was injected so that almost all of the banks, with the exception of the Agricultural Bank of China, are now considered to be beyond the worst of it.[45] On the management side, reorganization into joint stock companies, the attraction of strategic investors and the listing of shares have all helped to increase capital.[46] It should also be noted that the non-performing loan ratio had declined to the 6% range by the end of March of this year, and commentators noted that the absolute value was also steadily declining (Figure 11).

Figure 11: Non-performing loans at Chinese commercial banks



Note: Figures for 2004 cover the 4 large state-owned commercial banks and the 12 joint-stock banks; for 2005, urban commercial banks, rural commercial banks and foreign banks are included.

Source: Study Group documents (posted on China Banking Regulatory Commission website)

The Chinese authorities have stated clearly that while there have been improvements in various indicators, Chinese banks are still not up to the capacity of the leading foreign banks when it comes to either operations or risk management.[47] Commentators in the Research Group felt that there is still deep-rooted caution towards foreign banks in China.

Members of the Research Group noted several points to consider when looking at local Chinese banks, the first being whether their risk management capabilities are really being strengthened in line with initial targets. Local Chinese banks, primarily the state-owned commercial banks, are accepting investments from foreign banks that bring with them the management expertise of these banks to help strengthen their risk management systems and corporate governance. However, an opinion was expressed that, "Chinese banks have never experienced an

---

[45] The balance of non-performing loans held by banks in China (including foreign banks) at the end of 2006 was 1,254.9 billion RMB, of which 83.9% was held by the 4 large state-owned commercial banks, and a large portion of that figure was held by the Agricultural Bank of China.

[46] For China overall, only 8 banks had capital adequacy ratios in excess of 8% in 2003, but at the beginning of this year, that number had increased to 100. Banks with capital adequacy ratios in excess of 8% account for 77.4% of total bank assets in China (Business. Sohu.com., April 19, 2007). Three of the largest state-owned commercial banks have completed the process of attracting investments from "strategic investors" and listing their shares (end of 2006), and all of them have capital adequacy ratios in excess of 10% (Bank of China: 13.59%; Industrial and Commercial Bank of China: 14.05%; China Construction Bank: 12.11%).

[47] The Chinese authorities said, "Banking reform is still only superficial; the foundations remained weak." (comments made by Mr. Tang Shuangning, former vice chairman of China Banking Regulatory Commission, in the "China Financial Markets Forum" held in April of this year). Other comments introduced included, "Domestic commercial banks still lack core competitiveness and are backwards in their service concepts, risk management and IT. Even in operations where they have been traditionally strong, their share is declining and in new operations they are far behind foreign banks. They have little capacity to introduce new concepts and show insufficient brand management and internal control." (comments made by Mr.Li Lihui, President of the Bank of China in the Boao Forum for Asia in April of this year).

economic downturn since they introduced these reforms, and it will only be when the economy declines that we will see whether their efforts to strengthen risk management systems, particularly credit risk management, have been fruitful." In addition, banks have tried to strengthen their capital by listing their shares, but one important issue they face, according to Research Group members, is how they use the new funds they have acquired to improve their profitability.

(3) Points for the future

Finally, there are several points of reservation from the perspective of Japanese and other foreign banks regarding the opening of China's financial markets. First, in the event that banks establish local subsidiaries instead of branch offices and begin to do full RMB banking business, including retail RMB services, they will be required, under the principle of national treatment, to observe various commercial banking regulations, just like Chinese banks (Figure 12). Some are concerned that local subsidiaries may be unable to satisfy some of these regulations immediately, and bank participants have said that they would like to use the transitional measures that are allowed and dialogue with the Chinese authorities in order to find a path by which regulations can be satisfied with certainty. One Group member from a Japanese company felt that relative to the deposit/lending ratio regulations and large lending regulations, "There is great interest in future trends because the regulations imposed on banks have the potential to impact future fundraising in China."

In addition, the "US-China Strategic Economic Dialog" held in May of this year addressed further opening of China's financial markets, including the handling of card services by foreign banks and relaxed restrictions on security services by foreign brokerages, and agreements were reached on some issues. Participants stressed the importance of deepening mutual dialogue between Japan and China, including both industrial companies and financial institutions, in a "win-win" spirit in order to identify directions for further opening of financial markets in the future.

Figure 12: Main regulations applied to local-subsidiary banks

(Law of the People's Republic of China on Commercial banks Article 39)

Capital adequacy ratios	• Capital adequacy ratio not to fall below 8%
Deposit/lending ratios	• Outstanding loans / Outstanding deposits <= 75%
Large loans	• Outstanding loans to any single borrower <= 10% of capital
Liquidity ratios	• Outstanding liquid assets / Outstanding liquid liabilities >= 25%

Resource：Research Group documents.

6. Conclusion

This report has provided a summary of discussions held in the Research Group. These discussions have made us realize the significance that business in China holds for both Japanese companies and banks nowadays. As the Japanese and Chinese economies and financial systems become more closely interrelated, the issues and problems that the Research Group identified will confront not only Japanese companies and banks, but also Chinese companies and banks in their day-to-day operations. The Chinese regulators are very aware of these issues and problems, and have taken many steps to try to correct them. It is expected that these efforts will bring further improvements to the business environment in China and will benefit all companies and financial institutions active in China regardless of whether they are Chinese or foreign.

The Center for Monetary Cooperation in Asia, International Department, Bank of Japan, would like to continue its research and analysis concerning these issues mentioned above, and deepen our dialogue with relevant Chinese counterparts in a true "win-win spirit."

End of document